

Committee on Resources

Subcommittee on Water & Power

Witness Statement

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UNITED STATES DEPARTMENT OF ENERGY**

**BEFORE THE
COMMITTEE ON RESOURCES
SUBCOMMITTEE ON WATER AND POWER
UNITED STATES HOUSE OF REPRESENTATIVES
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Introduction

Mr. Chairman, distinguished members of the Subcommittee, my name is Paul Norman. I am the Senior Vice President for the Power Business Line at the Bonneville Power Administration (BPA), responsible to the BPA Administrator for BPA's power sales and operations. We appreciate this opportunity to appear today at this hearing on BPA's proposed Slice of the system power product. We thank you for your continued support and attention to issues affecting BPA and its customers.

Mr. Chairman, the Slice product is a new and innovative way of carrying out BPA's longstanding mission - that of selling power from the Federal Columbia River Power System (FCRPS) at cost to Pacific Northwest customers. As with any innovation, there were initially significant questions about Slice. Since our customers came to us with the Slice proposal almost three years ago, BPA has exhaustively examined the costs, benefits, and risks of this new approach to selling FCRPS power. We have conducted this examination through a public process, which has extended over nearly three years, a process which has been open to all interested parties. The conclusion we have reached through this multi-year examination, and which I will describe in this testimony, is that a limited amount of Slice sales is a reasonable addition to the overall mix of power products that BPA should offer in its new contracts.

In summary, our analysis indicates that the Slice product most likely has neutral to positive impacts on rates to BPA's other power customers who don't purchase the Slice product, on our ability to cover future cost uncertainties, on our ability to meet fish recovery obligations, and on our assurance of making Treasury payments. We believe that the Slice product is consistent with BPA's statutory authorities. Finally, since the Slice product is a significantly different product for BPA, we intend to limit the amount of Slice product sales to a relatively small fraction of our total power sales. That way, if any unanticipated problems with the Slice product crop up, their impact will be limited.

The Slice Product is Part of BPA's Subscription Process

BPA's public utility customers first proposed the idea for the Slice product during the development of Subscription in 1997. "Subscription" is BPA's process of offering and signing new contracts for sale of federal system power at cost to Pacific Northwest customers. These customers include consumer-owned utilities, investor-owned utilities, and direct-service industries. These new contracts replace existing contracts, which were signed in 1981 or 1996 and expire next year.

Subscription is of enormous importance to BPA and its customers. The Subscription contracts will provide a

stable revenue source to cover BPA's costs for the contract period. The contracts and rates are being structured to provide a higher assurance of meeting Treasury payment obligations than in any prior BPA rate case. Subscription provides BPA with the means to cover significant uncertainties in future costs, including fish recovery costs.

For customers, Subscription is the opportunity to sign up for a one to ten-year power supply at the cost of the federal system in return for assuming the responsibility to pay a portion of the FCRPS's power costs. For the region as a whole, Subscription is the opportunity to secure the benefits of the FCRPS for the region's power consumers. Subscription will substantially broaden the current distribution of benefits of the FCRPS to rural and residential consumers. It will also provide a significant sale of power at below market rates to the region's direct service industries.

Timely completion of Subscription is of paramount importance to BPA. Subscription contracting is scheduled to start in April and to be completed on September 30. Once the contracts are signed, there is a huge amount of operational and planning work to do before the new contracts go into effect 12 months later. There is major risk exposure if that 12-month lead-time is reduced. Foremost among the risks of delay involves BPA's obligation to purchase significant amounts of power to meet the Subscription contracts. Forcing these purchases into a narrower window could force the price of the power purchases up significantly.

A Brief History of Slice Product Development

BPA has conducted an extensive public process on the Slice product over the past three years. Virtually all Northwest parties and interests have had an ongoing opportunity to comment and have their concerns heard.

BPA began developing its Subscription policy in early 1997 through a series of public meetings as well as one-on-one briefings with customers and constituents. A group of our public customers first proposed the Slice product early in the Subscription process. Over the next year and a half, the Slice was the subject of extensive BPA analysis and numerous public meetings and workshops. In December 1998, BPA published its Power Subscription Strategy Record of Decision proposal documenting, among other things, its decision to offer the Slice product. BPA made this decision after considering almost 200 responses from parties throughout the region, comprising nearly 600 pages of comments.

After the Subscription ROD was issued, BPA conducted two months of working sessions on the Slice product that were open to all interested parties. BPA published a final product description for the Slice product on February 22, 1999, and gathered more public comment. In August 1999, BPA published its Initial Rate Proposal for 2002-2006 power rates containing the Slice product proposal. Then, in December 1999, BPA published a supplementary issue paper and the draft Slice prototype contract for public review and comment. BPA continues to refine this proposal and hopes to be in a position to move forward in the near future.

Description of Slice

Slice is a power sale to public utilities and co-ops entitled to preference and priority to BPA power. Slice is based upon a customer's annual net firm requirements load. As described in Section 5(b)(1) of the Northwest Power Act, net firm requirements load is the amount of each utility's retail consumer load that exceeds - or is net of - the amount of its firm power resources used for load. With the Slice product, if a customer's net firm requirements load is 70 annual average megawatts (MW), that customer can buy up to a one percent Slice - since 70 annual average MW is about one percent of the annual firm power output of the FCRPS. The customer also gets one percent of the nonfirm surplus power from the FCRPS. Under these circumstances, the nonfirm surplus can be anywhere from 0 to 20 average MW, depending on water conditions.

Unlike BPA's other power sales, the Slice power product is not shaped to the customer's retail load shape. Instead, the power is provided in the shape of BPA's generation on an hourly, daily, and monthly basis, as it is actually available on the federal system. The customer, not BPA, has to find ways of using or reshaping the Slice power to meet its actual load. The customers will have to buy power to fill in the gap when Slice provides less power than they need to meet retail load. They will have to store, exchange, or sell off the excess power when Slice provides more power than is needed for loads. The customer takes the risk that the cost of purchases exceeds the revenue from selling the excess.

If the FCRPS output declines, the Slice customer would take a proportionate reduction in its power delivery. The customer, not BPA, would have to purchase power to replace any reduction or loss in power output.

In return for getting a percentage of power from the FCRPS output, the Slice customer pays the same percentage of the actual costs of the FCRPS. There are no guarantees or limits on those costs. Like BPA, the Slice customer is obliged to pay the actual costs, whatever they turn out to be.

Slice power purchases are for ten years, with no ability for the customers to walk away because the costs go up or Slice output goes down. Contracts shorter than ten years would not provide sufficient time to balance the risks and benefits of purchasing Slice to the customers and to BPA. Shorter-term Slice contracts would create the possibility that customers would reap the benefits of good markets and water conditions and then not purchase Slice in the next contract period if it looked like the federal system costs would be above market in that future period. Shorter-term contracts likewise would not provide an assured source of revenue to pay potentially high costs of salmon recovery in the second five years.

Slice is conceptually a resource-based product limited by annual net load rather than a load-based product. However, it does not sell any part of the ownership or the right to operation of the FCRPS to the purchaser. Control of the hydrosystem operation stays with the Federal agencies now charged with making operational decisions. Based on its percentage, a Slice purchaser obtains only that power and service that is available under actual river conditions and reservoir operations. The Federal agencies manage the federal system for flood control, navigation, fish and wildlife, and other nonpower considerations, as well as for power output. BPA does not relinquish any of its authority for operational decisions on the river. Nor does BPA confer any control over its budgeting, spending, or financial management to Slice customers.

The Advantages BPA Sees in Slice

BPA sees four advantages to the Slice product. These advantages are what have motivated us to offer the Slice option. The four advantages are risk mitigation, reduced need for BPA to reshape the federal system output to the shape of public customers' loads, longer-term fish funding stability, and responsiveness to public customer needs.

Risk Mitigation: In BPA's other subscription power products, BPA sets rates and then absorbs the risks of cost fluctuations, uncertain water supplies, and market uncertainties through the rate period. The Slice product requires purchasers to bear nearly all those risks. These risks are significant. Probably the most significant risk is the variability of hydro conditions. In below-average water years, BPA has to meet its load obligations to non-Slice customers, even if those obligations exceed federal system generation output. BPA may have to purchase power to meet its load obligations, and it has to absorb these costs. The same thing is true if BPA loses generating capability due to outage or fish operations.

BPA has designed features into its other subscription products and its rates to mitigate these risks, so BPA absorbs them. Slice purchasers, on the other hand, in below-average water years will receive less power from the output of the federal system. They still have to meet their own firm consumer load obligations and if they have to purchase power to do it, they will absorb the costs.

Reshaping Federal System Output: With some other subscription products, BPA meets the shape of its

customers' loads daily, hourly, and monthly; regardless of what the federal system is generating at the time. This can be difficult and expensive, especially during events such as cold snaps in which loads soar and market prices spike. Slice purchasers take on the responsibility to shape BPA's generation to their own consumer loads. Slice purchasers, instead of BPA, will buy additional power as needed hourly, daily, or monthly to help meet their own loads.

Longer-Term Fish Funding Stability: One of Vice President Gore's 1998 Fish Funding Principles is that BPA's Subscription contracts must provide a high probability of covering the highly uncertain costs of salmon recovery post-2006. Since Slice contracts will be ten-year commitments to pay all BPA actual power system costs, Slice also helps provide more revenue certainty for BPA's post-2006 salmon recovery obligations.

Customer Needs: Some BPA customers believe that Slice provides them the best service to meet the needs of the consumers they serve, despite the risks they must bear.

BPA Has Addressed the Concerns Raised About Slice

When customers first came to BPA three years ago with the idea for Slice, we were initially skeptical. We wondered if such a product might hinder our ability to continue to meet our obligations to taxpayers and to the recovery of endangered salmon. We wanted to make sure our other customers were kept whole.

So BPA laid out five principles that a Slice proposal would have to meet before it would be acceptable to BPA and the Pacific Northwest region. The principles were:

1. No risk or cost shifts to other customers;
2. No risk or cost shifts to taxpayers;
3. No avoidance of fish costs;
4. No interference with operations; and
5. No changes in law required.

Through an enormous amount of analysis and public consultation, BPA and potential Slice purchasers have designed a Slice product that we believe complies with these fundamental principles, plus some additional concerns that arose as the process proceeded. I will summarize our conclusions on each concern.

No Risk or Cost Shifts to Other Customers: As I have described, a primary advantage we see to Slice is that it tends to shift risk from BPA to the Slice purchasers. If BPA costs go up, Slice customers pay their share of the increase. If federal system power production declines, Slice customers make market purchases to replace it. Our rate case analysis also shows Slice is revenue neutral, meaning that it results in no significant cost shifts from Slice customers to BPA or its other customers. Given how distinctly new the Slice product is, there are inevitable uncertainties about the cost-shift analysis. But we are satisfied that these uncertainties are acceptable, given our intended limitations on the total amount of Slice product sales.

No Risk or Cost Shifts to Taxpayers: For the same reasons that Slice avoids risk and cost shift to other customers, the taxpayers are also protected. Perhaps most significantly, under Subscription the Slice product requires customers to make a ten-year contract commitment to pay their share of BPA costs. The greatest uncertainties in BPA's costs exist beyond 2006. Slice customers must commit to bearing those cost risks, even if BPA costs rise above market prices. This provides significant longer-term protection to the taxpayer.

No Avoidance of Fish Costs: Slice purchasers will pay BPA's actual costs for fish recovery. If BPA and other Federal agencies must further reduce power generation levels for fish, Slice purchasers will shoulder their proportionate share of the lost generation. If fish program costs increase, Slice customers pay their share, even if those costs were to drive FCRPS costs above market prices. This commitment from Slice customers extends for the full ten-year duration of the contracts. Slice customers are not able to walk away

from their purchase obligation because fish costs increase. As previously explained, this longer-term stability of fish funding is a key part of BPA's program to meet the Fish Funding Principles announced by Vice President Gore in 1998.

No Interference with Operations: Control of the federal system stays with the federal operators. Slice purchasers agree to not contest the results of the operating decisions of the Federal entities, including decisions relating to any nonpower requirement being added to or deleted from the federal system obligations.

No Changes in Law: We believe BPA has the legal authority to offer the Slice product to its Northwest preference customers as a power product, which provides both net firm load requirements power and an advance sale of surplus power, as it becomes available. Slice is simply a different contractual means of providing those power products and services that public customers can already request under current law.

Addressing Slice Purchasers' Financial Risks

BPA is satisfied that Slice satisfies the five principles we specified. But it also became clearer to us as we developed this product that Slice purchasers were accepting significant risks, risks that perhaps not all of them were prepared to face.

As described earlier, the risks that Slice customers are undertaking are substantial. Dry water years could force them into the volatile spot market to meet their loads and those costs could be huge. Even with good water conditions, federal system power output could be further reduced to benefit fish. BPA could incur significant new costs that would be difficult for customers to absorb. BPA has not disguised these risks from the public utilities. We have explained them during the customer work group meetings and other public meetings. BPA has conducted several Slice "dry runs." These simulations give potential Slice purchasers the opportunity to experience what would happen operationally with Slice and to experience the risks directly.

If a public utility does not have sufficient financial strength, and/or has not instituted sufficient risk mitigation measures, they could have difficulty meeting their payment obligation to BPA, if and when these adverse events occur. Since the primary benefit of Slice to BPA is risk protection, we intend to require each buyer to demonstrate its ability to handle Slice risks as a condition of signing a Slice contract. BPA routinely imposes credit limits and creditworthiness checks on marketers, and imposition of this requirement on public preference utilities is not unprecedented in BPA's history.

Resale of Federal Power

Another issue is whether the Slice product gives purchasers an unfair market advantage. BPA has appropriately priced the Sliced product and does not believe Slice would, in fact, give purchasers of the product any unfair advantage.

Slice customers would be required to use the power they receive under the Slice contract to meet their retail consumer load first. Only some portions of the product may be resold. They may use the occasional surplus power to displace their higher-cost operating resources and then, in turn, resell their displaced power to other parties on the wholesale market. They may also store, exchange, or resell BPA surplus power that they receive through the Slice product, subject to the same statutory requirements to which BPA is subject. If they resell BPA surplus power outside the region and it is needed in the Northwest, BPA may recall the exported surplus.

The Slice product does include an advance sale of surplus power which becomes available to the system, along with the firm requirements power. But the Slice customers have a preference right to purchase available surplus power ahead of other purchasers even without Slice.

In summary, Slice customers get no more power from BPA, at no lower a cost, than they would be able to request from BPA without Slice. Further, the same restrictions on resale of federal power apply to Slice sales as apply to other requirements sales or surplus sales by BPA. Accordingly, it is BPA's belief that Slice would not increase the ability of public preference customers to use federal system power to compete in the marketplace.

BPA's Planned Approach to Slice

As described above, our analysis indicates that Slice is likely to offer risk mitigation benefits to BPA, as a limited part of BPA's overall Subscription power sales. We believe we have taken great care to ensure that cost shifts and other difficulties are avoided. Slice is a significant departure from past products and we are reluctant to put too many eggs in an as-yet-untested basket. Primarily for that reason, we intend to limit Slice sales as part of our Subscription contract offers to between 15 to 25 percent of the federal system output (1150 to 2000 average firm MWs). This limit will provide a final measure of assurance that any surprises in how Slice works will be manageable. Our intent is to move forward with customer-specific Slice contract negotiations starting this month and to conclude these negotiations by September 30, as part of the overall Subscription process.

Conclusion

Mr. Chairman, members of the Subcommittee, thank you for your attention. I have tried to explain why we think the Slice product is a reasonable and sensible innovation in the way BPA carries out its power marketing mandates, at the limited level at which we intend to sell it.

I would be happy now to answer any questions you may have about my testimony.

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